

VZCZCXRO1224  
RR RUEHIK RUEHLN RUEHPOD RUEHVK RUEHYG  
DE RUEHKV #3165/01 3621258  
ZNR UUUUU ZZH  
R 281258Z DEC 07  
FM AMEMBASSY KYIV  
TO RUEHC/SECSTATE WASHDC 4641  
INFO RUEATRS/DEPT OF TREASURY WASHDC  
RUCNCIS/CIS COLLECTIVE  
RUCPDOG/DEPT OF COMMERCE WASHDC  
RUEHZG/NATO EU COLLECTIVE

UNCLAS SECTION 01 OF 06 KYIV 003165

SIPDIS

TREASURY FOR LEE  
DEPT PLEASE PASS USTR FOR CKLEIN/LMOLNAR  
USDOC FOR 4201/DOC/ITA/MAC/BISNIS  
USDOC FOR 4231/ITA/OEENIS/NISD/CLUCYK

SENSITIVE  
SIPDIS

E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [ENRG](#) [EINV](#) [PGOV](#) [PREL](#) [UP](#)

SUBJECT: ECONOMIC POLICY AND THE NEW GOU: PROGRESS, BUT WITH  
PRODDING

Ref: A: KYIV 2336; B: KYIV 3058; C: KYIV 2985; D: KYIV 2892; E:  
KYIV 1962; F: KYIV 2857

Sensitive But Unclassified. Not for Internet Distribution.

11. (SBU) Summary and comment: Prime Minister Yulia Tymoshenko has sent out mixed signals on her plans for the Ukrainian economy. She continues to say many of the right things on economic matters, yet some of her populist campaign promises convey a different message. Nonetheless, we expect Tymoshenko to be open to well-timed recommendations on how best to improve the investment and commercial climate. Her choice of ministers for the key portfolios of energy and finance is encouraging, and we expect them to be more willing than their immediate predecessors to address some of the more egregious problems facing public finances and the energy sector. The coalition's razor-thin majority in the Rada (parliament) will make progress difficult, however, and many reform measures will unavoidably affect entrenched interests within the ruling coalition itself, testing Tymoshenko's ability to hold her government together.

12. (SBU) We expect Tymoshenko to tackle gas relations with Russia and to address the question of intermediaries, even if she may still not have decided on specifics of her approach. It is also likely that she will maintain momentum on WTO accession, follow up on her campaign promises to address corruption, and avoid a repeat of the re-privatization policies of her first term as PM. The budget deficit will likely grow as the new GOU tries to keep social spending and wage increases ahead of inflation, which will reach about 15 percent in 2007 and remain high in 2008. The ban on sales of agricultural land will continue for the time being due to disagreements among the coalition partners. Because of its thin majority in the Rada and its conflicting goals, the new government will need to be prodded on an ongoing basis to remain on track with economic reforms. In our discussions with the new GOU, Embassy plans initially to focus on discrete measures to improve the investment climate, such as corporate governance legislation and resolving the OPIC dispute, as well as addressing VAT refund arrears, completing WTO accession, and enhancing energy security. End summary and comment.

A Chance For Reform, But With Lots of Prodding  
-----

13. (SBU) Tymoshenko's own track record in government and her campaign promises have sent mixed messages about her true intentions on economic policy. In her "Contract With Investors" (ref A), she said all the right things about the need to accelerate economic reform in Ukraine. At the same time, her campaign rhetoric was

often purposely populist, with some anti-reform undertones. Tymoshenko's populist rhetoric can be over-interpreted, however, and she is likely open to economic reform. She is also very sensitive to her reputation in the western world, so we expect her to listen to well-placed messages on the need to move forward with reform. We expect the new ministers with the most important economic portfolios -- Finance Minister Pynzynyk, Energy Minister Prodan and Economy Minister Danylyshyn -- to be both readily accessible and open to ideas on how best to improve Ukraine's economic and investment climate. Nonetheless, the new government will need to be pushed into action, since enacting reforms will be challenging. The razor-thin majority in the Rada will make progress difficult, particularly when reforms affect deeply entrenched interests within the new ruling coalition itself. Many reform measures, such as strengthening budget discipline, will be highly unpopular (Comment: potentially affecting any chances for Tymoshenko to run for President in 2009.) and contradict populist promises that she made during the campaign. And finally, many measures will demand long-term political focus, discipline and staying power, all of which are not widespread in the short-term realities of Ukrainian politics, and could be in particularly short supply for a government that will invest much of its energy and political capital in keeping its coalition together.

#### Economic Conditions Will Likely Remain Favorable

-----

14. (SBU) The economic environment should remain generally favorable for the new government in 2008. Continued strong economic growth will give the government room to maneuver, although growth is expected to slow somewhat, from about 7 percent in 2007 to roughly 5 percent in 2008. High world prices for Ukraine's steel and chemical exports have favored economic growth in the past two years. Consumer spending and business investment will likely remain strong.

KYIV 00003165 002 OF 006

At the same time, risks do exist. Were prices for steel and chemical exports to drop, there would be a major ripple effect on Ukraine's growth, and particularly a worsening of the growing current account deficit. Inflation, about 15 percent in 2007, will remain high. The new government has already increased its inflation forecast for 2008 to 16 percent. Keeping inflation under control could be the most difficult economic challenge facing Ukraine in the coming year. Like the outgoing government, Tymoshenko's government could be tempted to combat inflation with administrative measures such as price and export controls. There will also be pressure on the new government to use the budget to keep wages growing at least as fast as inflation. Some believe that the risks in Ukraine's booming banking system, which has depended greatly on foreign borrowing for growth, might become critical if the worldwide credit crunch continues far into 2008. Large capital inflows are now funding the current account deficit, and this should continue next year unless the credit crunch worsens.

#### Gas Relations With Russia: Expect Changes

-----

15. (SBU) Tymoshenko has regularly criticized the outgoing government's track record of gas politics vis-a-vis Russia. She has vowed to abolish intermediaries RosUkrEnergo (RUE) and UkrHazEnergo (UHE), and to place Ukraine's energy relations with Russia on a new footing. No one doubts her intentions, but it is not clear how she plans to approach gas relations with Russia. It is possible that even she and her top energy advisors do not yet know. Although Tymoshenko at one point suggested that the GOU take Russia to international arbitration for violating the 2004 agreement, her pronouncements lately have been less provocative. In the short term, she will likely have no realistic alternative to the 2008 price hike that was negotiated in early December between the outgoing government and Gazprom. (Note: In 2008 Ukraine will pay \$179.50 per tcm, up from \$130 this year. End note). She will also need to acknowledge, at least temporarily, the presence of RUE and UHE in the market. As her track record shows, however, Tymoshenko is not afraid to take on entrenched economic interests in the energy sphere, so it is safe to assume that she will try to follow up on her campaign promises in the medium term. Ukraine still needs to

define and implement a long-term energy strategy with Russia that envisages market-based pricing for energy imports, diversification of energy supplies and modernization and improved management of the gas transit pipelines and the domestic distribution network. Taking on the vested interests that benefit from the lack of transparency in Ukraine's gas sector will require strong political will and support. Tymoshenko may have the former, but the question is whether she has the backing to reform this sector.

#### New Government Will Maintain Momentum on WTO

-----

16. (SBU) Maintaining the momentum on WTO accession will be a top priority of the incoming government. The GOU still needs to find a solution with the EU on export duties, the last remaining major hurdle to Ukraine's joining the WTO. Ukraine also still needs to amend about 10 laws and regulations as part of its WTO commitments to the U.S. The outgoing government promised to do this in omnibus legislation that the Rada would pass at the time it ratifies Ukraine's WTO accession. If the new GOU reaches agreement with the EU soon, the accession could be put before the Rada sometime in the first quarter of 2008. Despite its small majority, the new government should be able to push the necessary changes through the Rada. All of Ukraine's major political parties (aside from the Communists) have committed to finalizing WTO accession as soon as possible. The vote to ratify WTO accession may give Tymoshenko an opportunity to generate broad bipartisan support for an important piece of legislation.

#### Energy Minister Prodan: A Step in the Right Direction

-----

17. (SBU) The choice of Yuriy Prodan as Minister of Energy and Fuels is a positive step. His immediate predecessor, Yuriy Boyko, was widely seen as a corrupt insider with close ties to Russia. Prodan often criticized Boyko's plans for Ukraine's energy market, which Prodan felt were a thinly disguised attempt to privatize strategic energy assets. Prodan and the CabMin have already abolished UkrAtomProm, created by Boyko and outgoing EnergoAtom President Andrey Derkach in a move that many feared was a first step towards stealth privatization of Ukraine's most important nuclear energy assets. Prodan has a generally favorable track record as regulator of Ukraine's electricity market, where he was seen as a

KYIV 00003165 003 OF 006

professional, independent player capable of defending a strong position as well as someone who could find compromises. He also worked closely on power market issues with Tymoshenko when she was deputy prime minister for energy and is reported to have a good working relationship with her. He is also known to be loyal to President Yushchenko. Prodan is largely an outsider to the murky world of Ukraine's gas sector. This may be good news, since unlike Boyko, who earlier served as CEO of NaftoHaz, Prodan has no vested interests in the gas sector. Significantly, the new CEO of Naftohaz, Ihor Dubyna, also is not a NaftoHaz insider.

#### Nuclear Energy: Fewer Roadblocks to Cooperation

-----

18. (SBU) We experienced numerous roadblocks to cooperation in the nuclear sector under Derkach and Boyko, and expect the situation to improve under Prodan. While at the National Security and Defense Council, Prodan told us that he backed the Nuclear Fuels Qualification Project, and we expect him to be supportive of efforts to get EnergoAtom and Westinghouse to reach agreement on the commercial aspects of a nuclear fuel supply deal. We also do not expect Prodan to thwart progress on the construction of a central spent fuel storage facility in Chernobyl (a project won by U.S.-based Holtec) as Derkach at EnergoAtom had tried to do. Much will depend on the new President of Energoatom. There is some speculation that former Energoatom CEO Yuriy Nedashkovskiy, who is currently an acting Deputy Minister of Fuel and Energy, will return to his old job. Nedashkovskiy supported the Holtec project in the past. In any case, under Prodan and a new Cabinet there is hope for more opportunities for non-Russian FDI in the nuclear sector. Recent press reports indicate that France and Canada are actively

studying possibilities to enter the Ukrainian market to provide technology for the construction of new reactors.

#### Rescuing NaftoHaz from Bankruptcy

---

¶9. (SBU) The precarious financial situation of state-owned energy company NaftoHaz (ref B) is already demanding the immediate attention of the new Cabinet. The new government has announced that it will provide subsidies and guarantees to avert bankruptcy at NaftoHaz. Administratively set prices currently force NaftoHaz to sell gas to households and municipal heating companies at below cost. To put the company on a more stable financial footing in the longer run, the new government will need to allow significant price hikes for gas and heat rates, creating a conflict with Tymoshenko's more populist campaign promises to shield the public from rising prices for municipal services.

#### Combating Corruption Will Test Tymoshenko's Will

---

¶10. (SBU) Tymoshenko has promised to make combating corruption a top priority. On her first day in office she announced that all state agencies would immediately undergo what she called a corruption audit. Corruption is endemic in Ukrainian political and commercial life, and any successful and sustainable anti-corruption campaign cannot avoid hitting the interests of some business and political interests within the ranks of the ruling coalition, including those of some of Tymoshenko's wealthiest and most influential supporters. Tymoshenko's determination to follow through on her anti-corruption campaign promises will likely be challenged on a repeated basis, and will test her ability to exercise discipline over her coalition.

#### OPIC and the Need for Action on Euro 2012

---

¶11. (SBU) The Overseas Private Investment Corporation (OPIC) is not insuring new investments in Ukraine because of repeated Ukrainian governments' inability to pay off a claim linked to an expropriation case. OPIC's return would support increased U.S. investment in Ukraine. In its final weeks in office, the outgoing government made promising overtures to pay off the claim, yet it is still unclear whether the new government will maintain the momentum or opt to start the process from the beginning. The new government will also need quickly to address the challenges surrounding the staging of the European soccer championships in 2012 (ref C). This massive event, a nearly month-long circus of matches with 16 national soccer teams, hundreds of thousands of visitors and countless journalists, should unleash an investment boom, stimulate further economic liberalization and allow Ukraine to showcase itself to Europe. However, the event requires coordinated public sector support, and

KYIV 00003165 004 OF 006

the outgoing government did little despite lots of rhetoric. The new government highlighted the importance it attaches to this effort by appointing veteran official Yevhen Chervonenko as Euro 2012 coordinator with the rank of Deputy Prime Minister. If the new GOU fails to act effectively, Ukraine might actually lose the games, which would be a blow both to the investment climate and to Ukraine's image in Europe.

#### Re-Privatization: No Repeat of 2005 Expected

---

¶12. (SBU) Tymoshenko made clean and transparent privatization a central theme of her election campaign and a leading indictment of the Yanukovich government. It is reasonable to expect that her government will attempt to bring more accountability and openness into Ukraine's privatization policies. None of the country's most powerful businessmen and Party of Regions supporters can expect to manipulate privatizations as long as Tymoshenko is in power. However, both BYuT or OU-PSD have wealthy and influential businessmen in their ranks, and Tymoshenko's proclaimed intention to attack corruption in privatization could be seriously tested if any of them attempt to manipulate privatizations to their own advantage.

Much will depend on the political and bureaucratic acumen of whoever is chosen to lead the State Property Fund. Since becoming PM, Tymoshenko has already announced that she plans to "review" some of the privatizations conducted under the outgoing government. However, nobody expects Tymoshenko to repeat the re-privatization policies of her first term as Prime Minister. During the election campaign, Tymoshenko vowed to return to state control certain companies sold under the Yanukovych government, most notably DniproEnergo, partially sold to Party of Regions financier Rinat Akhmetov in a non-transparent debt-for-equity swap (ref D). Tymoshenko later changed her rhetoric, and is now saying that any questionable privatizations will be addressed in Ukraine's court system.

#### Pynzenyk: A Good Choice Who Speaks His Mind

-----

¶13. (SBU) The appointment of Victor Pynzenyk as Minister of Finance was widely applauded in Ukraine. He is recognized as knowledgeable, serious with broad experience in government, including a stint as Finance Minister under Tymoshenko's last government and under Tymoshenko's successor Yekhanurov. He is a fiscal conservative who is not afraid to speak his mind. In a meeting with the Ambassador prior to the elections, Pynzenyk criticized Tymoshenko for paying too much attention to social themes while ignoring the importance of social and economic reform. Ukraine's system of social benefits was "expensive and immoral" and making people too dependent on the state, he said. He acknowledged that he was a minority within BYuT, and as Finance Minister he will likely face political pressure to maintain high levels of social spending. (Comment: To be fair, outgoing Finance Minister Mykola Azarov was also a fiscal conservative, and lamented to the Ambassador that he could not withstand pressure to maintain what he felt were excessively high levels of social spending. End comment.)

#### Budget Deficit to Rise as Lost Savings Are Repaid...

-----

¶14. (SBU) Pynzenyk has already submitted a new draft budget to the Rada. The expected budget deficit will rise because of increased social spending. Tymoshenko had promised to remove what she has called grossly corrupt state subsidies to the energy sector, in particular a UAH 1 billion (\$200 million) cut in coal subsidies. While it is expected that many of the subsidy cuts will target businessmen affiliated with the Party of Regions, the cutbacks could also affect well-positioned business interests within the ruling coalition, testing Tymoshenko's political resolve and the ability of the coalition to manage a conflict within its own ranks. Tymoshenko is also moving forward with her promise to reimburse Ukrainians who lost about UAH 120 billion (\$24 billion) in savings at the state-owned USSR Sberbank (now Oshchad' Bank in Ukraine) during the hyperinflation of the early 1990s. Pynzenyk's new draft budget includes UAH 20 billion as a first step to reimburse lost savings, which he proposes to fund through increased privatizations. Most outside economists fear the reimbursement could prove an inflationary stimulus in 2008.

#### ...And Social Spending to Remain High

-----

¶15. (SBU) Strong increases in public sector wages, pensions and the

KYIV 00003165 005 OF 006

minimum wage have fueled economic growth and the boom in private consumption in recent years. The new government will face broad pressure to maintain high levels of such spending, particularly since inflation will remain high in 2008. Tymoshenko will also be careful not to risk alienating voters in the run up to the 2009 presidential elections. Yanukovych's draft budget limited social spending to 30 percent of total budget outlays, down from 46 percent and 52 percent in 2006 and 2005, respectively. We expect Tymoshenko will probably be inclined to reverse this trend.

#### Value Added Tax: Hoping for End to Corruption

-----



¶16. (SBU) Corruption surrounding VAT refunds spiked under Yanukovych and Azarov. Both foreign and Ukrainian firms told us that the State Tax Administration (STA) demanded bribes between ten and thirty percent of the outstanding refunds to process VAT claims. We hope the problems surrounding VAT refunds will improve significantly under Pynzenyk, who by all accounts has a clean image and in whose previous tenure as Finance Minister arrears of VAT were significantly reduced. Because of the large amount of outstanding VAT refunds, we do not expect him to solve the problem quickly, but we will want to ensure that he makes the issue a priority. Much will also depend on Serhij Buryak, the new head of the STA, whose views on the issue are unknown. During the election campaign, Tymoshenko also promised to clean up tax administration and replace VAT with a type of end user tax. Most observers doubt whether Tymoshenko will ultimately undertake the complex task of introducing the new tax, and Pynzenyk, although critical of current VAT administration, would likely oppose such a move. Before the elections he told the Ambassador that, should he become Finance Minister, he would resign if Tymoshenko attempted to abolish VAT.

#### Fixing the Procurement Mess

-----

¶17. (SBU) The public procurement system has been effectively expropriated by vested economic interests representing most parties in the Rada (ref E). Amendments to the State Procurement Law, adopted in March, worsened the situation, with purchases by many government agencies almost coming to a halt. Anecdotes abound on the destructiveness of the current procurement regime. This year's relatively modest budget deficit is partly due to the government's inability to spend on procurement. In another example, the planes of the Ukrainian air force were grounded for four months because of an inability to purchase fuel. Addressing the procurement system should be a top priority, but the coalition will run up against interests in its own ranks if it does so.

#### Addressing Long Overdue Commercial and Tax Legislation

-----

¶18. (SBU) Some laws that would modernize commercial life in Ukraine made little or no progress under the Yanukovych government. For example, a draft law that would overhaul Ukraine's tax system is stalled in the Rada. A draft joint stock company law, which would strengthen the rights of minority shareholders and prevent many of the expropriation cases that are all too common in economic life, has languished in the Rada for years. Most experts agree that the country's poorly drafted commercial code is not needed and should be withdrawn. Ukraine is also in desperate need of a new Labor Code based on market principles. While domestic and international experts have long advocated reforms in all these areas, Tymoshenko's willingness to address them is questionable. These issues did not have a prominent place in her program, and reportedly some of her business supporters oppose them.

#### Ending The Land Sale Moratorium: No Solution in Sight

-----

¶19. (SBU) The moratorium on the sale of agricultural land represented a major policy difference between BYuT and OU-PSD during the election campaign, and it will likely continue to serve as a sticking point between the coalition partners in the near future. Tymoshenko, however, appears to have taken a step back from her aggressive campaign platform which hinted at keeping the moratorium in place indefinitely (ref F). She acknowledged that the current laws only engender a large black market for lands and that legislative reforms are necessary. In the mean time, Yushchenko and his team continue to make the issue a priority, as the Presidential Secretariat has fine-tuned the two laws necessary to lift the

SIPDIS

moratorium with the hope of passing them through the Rada in the next several weeks. Due to the difference with BYuT, however, it is

KYIV 00003165 006 OF 006

unlikely that the legislation will move swiftly. The prospects for quick action could be further dimmed if an attempt is made to draw

the Litvyn Bloc, which wants to extend the moratorium by at least two years, into the ruling coalition.

PETTIT